

TO: Files

CC: San Diego Audit Committee

FROM: Willkie Farr & Gallagher LLP

RE: Interview of Chuck Woolever on April 20, 2006

DATED: May 24, 2006

On April 20, 2006, Carolyn Miller, in Willkie Farr & Gallagher LLP's capacity as counsel to the Audit Committee, interviewed Chuck Woolever. Mr. Woolever was not represented at this interview. Also in attendance were Lynn Turner of the Audit Committee, Donielle Evans of KPMG and Ray Sarola of Willkie. The interview took place in a conference room on the 3rd floor of the City Administration Building in San Diego and lasted approximately two hours.

The following memorandum reflects my thoughts, impressions, and opinions regarding our meeting with Chuck Woolever, and constitutes protected attorney work product. It is not, nor is it intended to be, a substantially verbatim record of the interview.

Warnings

Ms. Miller informed Mr. Woolever that she represents the Audit Committee and not him personally, and as a result, no attorney-client privilege between the Audit Committee and him would cover this interview. She stated that information provided by Mr. Woolever may be made public in the Audit Committee's report, or provided to the government or KPMG. Ms. Miller told Mr. Woolever that information he provides will not be shared with other witnesses and asked that he not disclose the substance of this interview to others who are yet to be interviewed. Mr. Woolever had no questions about the interview procedure. Ms. Miller asked if he reviewed any documents in preparation for this interview and he responded that he did not.

Background

Ms. Miller asked Mr. Woolever to explain his education and employment history. Mr. Woolever has a Bachelor's and a Master's degree in Political Science. He began working for the City as a Budget Analyst in the Financial Services Department. He then became a Committee Consultant for the City Council Financial System before taking a position as the Assistant Planning Director in the Planning Department. He is currently the Deputy Director of Environmental Services. In this position, he serves as a division manager for the City's Collection Services.

Ms. Miller asked Mr. Woolever to explain how he came to serve on the SDCERS Board. He replied that starting in either 1988 or 1989, he served one six-year term on the

SDCERS Board. He was elected as a representative for the General Members after his co-workers submitted the petition for his candidacy, and had no prior background with pension issues, other than being a plan participant himself. Ms. Miller inquired about his interaction with the SDCERS Board before getting elected, and Mr. Woolever replied that he had never attended a SDCERS Board meeting or had any contact with the Board prior to that time. At the conclusion of his service, he met with John Torres, his successor, and handed him all his materials and records. Ms. Miller asked if he was compensated for serving on the SDCERS Board and he replied that he was not compensated other than being a City employee.

Mr. Woolever thought that he was targeted to be removed from the Board by the labor unions, who he believed were opposed to his support for the City's underfunding proposals. Judie Italiano (MEA President) interviewed him prior to the election in which he was defeated, though Mr. Woolever did not recall the substance of this meeting. He did recall heated Board meetings regarding the decision to grant the City temporary relief and stated that he wrote a brief around this time explaining his support for the underfunding proposals. Ms. Miller asked if there was any other reason the unions would have opposed his candidacy, and he replied that he could not think of any.

SDCERS Procedure

Ms. Miller asked Mr. Woolever for his understanding of his role as a SDCERS Board member. According to Mr. Woolever, his role as a Board member was to oversee the use of the system funds for the plan beneficiaries. He noted that the full Board makes decisions on the benefits to be paid out in particular cases. All Board members served on a committee, though members rotated between committees over time.

Ms. Miller then asked Mr. Woolever to describe the structure of SDCERS. At the time Mr. Woolever began his service on the SDCERS Board, the SDCERS staff was smaller. Lawrence Grissom was the Administrator, and Mr. Woolever described him as a "one horse show." Over time, SDCERS increased its staff, including assistants and an investment official to work with the investment advisors.

There were presentations to the SDCERS Board from Rick Roeder and outside consultants to train Board members but Mr. Woolever did not recall if he received special training when he first joined the Board. He explained that the Board met monthly and Board members would receive a packet of materials in advance of each month's meeting. Mr. Woolever never believed the materials provided were inadequate and noted that if he had questions, he could have asked staff at the meetings. Furthermore, Mr. Woolever stated that the bulk of the Board's work was dealing with individual cases and so he did not know what additional research would have been necessary. The materials he received every month contained the financial information for the fund and the agenda for the upcoming meeting. Ms. Miller asked if he ever engaged in additional research concerning the financial matters presented, and he replied that he did not. Ms. Miller asked how the financial information was presented and he responded that the actuary and investment managers prepared reports. Mr. Hogquist stated that these seemed to him to be complete reports, and if he had any questions he would take notes when he read the reports and ask SDCERS staff or a consultant at the next meeting. Ms. Miller then asked how one might place an item on the agenda for an upcoming meeting. Mr. Woolever believed that one could add an item to the agenda by contacting the Administrator or Board

President, or by raising the issue at the meeting. Mr. Woolever himself had asked that two items be added to the agenda: reciprocity with CALPERS (California Public Employees' Retirement System) and the same veteran's benefits as CALPERS. The latter item eventually became the purchase of service credit program ("PSC"). Mr. Woolever was unable to get the Board to agree to provide the same veteran's benefits as CALPERS, so the PSC program was a compromise.

Mr. Woolever did not recall any training specific to issues relating to conflicts of interest of Board members. While there may have been discussions with the City Attorney's Office on this issue, these discussions would have been held on a case-by-case basis. Mr. Woolever never had to make any conflict disclosures and was not aware of other members having problems in this area.

Corridor Funding and Contribution Relief

Early in Mr. Woolever's service, the fund was doing well. At the time the City sought contribution relief, he believed the plan was 96% funded. Mr. Woolever thought that the IRS had told SDCERS to reduce this number by either increasing benefits or reducing contributions.

Ms. Miller inquired about Mr. Woolever's knowledge of "corridor funding" and he responded that he participated in discussions regarding the corridor funding concept. Around the time of these discussions, the City was looking for a consistent funding program because it always had a "tight budget." The SDCERS Board had approved an earlier plan for contribution relief, but rescinded its approval when it received legal advice that the relief was unlawful. Ms. Evans asked who would have voted on the City's contribution holiday, and Mr. Woolever responded that the Board never voted on a contribution holiday; it only voted to approve a system of contribution relief. The corridor concept was introduced at or around this point as another option for reducing the City's contribution. Mr. Woolever noted that the Board received legal advice before voting on the relief structure. Mr. Woolever believed that contribution relief was akin to an 8% loan to the City because the City ultimately owes an amount equal to the full liability of the system.

Mr. Woolever was shown a March 6, 1993 memorandum from Ron Saathoff to Larry Grissom regarding questions to be asked of the Board's fiduciary counsel (Exhibit 1). Mr. Woolever did not recall whether he had seen this document before, and stated that he did not recall specifics of discussions involving corridor funding.

Ms. Miller asked if Ron Saathoff (Firefighter's Union President) was involved in the City's proposal for contribution relief. Mr. Woolever explained that Ron Saathoff was variously a committee chairman and the Board president, but he did not recall who made the motions for contribution relief. Mr. Woolever could not recall who was on the Corridor Concept Subcommittee, which was formed after earlier contribution relief was found improper. Ms. Miller asked why the Board needed to develop a funding proposal rather than the City making a proposal, and he replied that he did not recall. Ms. Miller asked if he thought at the time that a level funding plan was acceptable for SDCERS. Mr. Woolever believed that level funding was appropriate because the City was "not seeking permanent relief; they were seeking relief to help with the budget." He noted that the Board had legal counsel from the City Attorney's Office to advise them on this decision. He thought this proposal would not hurt benefits, but would

prevent layoffs. Ms. Miller then asked if the City ever discussed layoffs in this context. He replied that this belief was the product of his own experience as a manager, and that the City never discussed layoffs in this context.

Mr. Woolever was shown a February 17, 1994 memo from Jack McGrory (City Manager) to SDCERS regarding the City's contribution responsibilities to the system (Exhibit 2). Mr. Woolever stated that he probably saw this memo around the time that the Mayor was seeking relief. It was possible that Mr. McGrory may have submitted related items for an SDCERS vote. When asked what other City employees had contact with the Board, Mr. Woolever identified Lorainne Chapin (SDCERS General Counsel), Rick Duvernay (Deputy City Attorney), and Jack Katz (City Attorney's Office). Mr. Woolever did not think that the Mayor or City Councilmembers had contact with the SDCERS Board.

SDCERS' Use of Outside Professionals

The SDCERS Board had a selection process for the retention of outside consultants, but Mr. Woolever did not recall the specifics of this process. Ms. Miller asked for his impression of the work performed by outside experts, and he responded that he never questioned the abilities of any of the outside consultants, but would sometimes question their analyses. During his service, the SDCERS Board hired in-house counsel--initially, Rick Duvernay--and retained outside law firms to advise on various matters. Ms. Miller asked if the Board ever sued its outside counsel and Mr. Hogquist responded that they had, but he did not recall the specifics of this lawsuit.

Rick Roeder (SDCERS Actuary) prepared annual financial reports for the fund, as well as follow-up reports on actuarial matters. He was always available, but not always present at Board meetings. Mr. Woolever thought that Mr. Roeder was good, but questioned whether Mr. Roeder's 8% investment return rate was too high. Mr. Woolever noted that the Board changed some of this actuarial methodology during Mr. Roeder's term of service.

Actuarial Valuation Methods

Regarding actuarial methods, Mr. Woolever did not recall the Projected Unit Cost ("PUC") and Entry Age Normal ("EAN") methods of actuarial analysis, but remembered studying this issue at the time he was on the Board. According to Mr. Woolever, there was a lot of debate concerning these approaches. Ms. Miller asked why the Board was considering changing actuarial valuation methods and Mr. Woolever replied that he believed the reason the Board was considering changing the valuation method was because the fund could not be more than 100% funded, so the Board was trying to reduce the City's contribution. Ms. Miller then asked if the City had asked the SDCERS Board to reduce the rate. Mr. Woolever replied that he thought the concept came from the City Manager after the Board was unable to grant the contribution holiday requested by the Mayor.

Mr. Woolever was shown a May 14, 1991 memo from Mr. Grissom to Bruce Herring (Deputy City Manager), discussing the savings to the City contribution rate from the switch to PUC (Exhibit 3). Ms. Miller asked if this document refreshed Mr. Woolever's recollection of this issue. He replied that it did not. Mr. Woolever stated that he was a member of the Meet & Confer negotiating team a number of times, but could not recall which years. He

stated that the City negotiated pension benefit increases in lieu of salary increases because it did not have the ability to pay salary increases at that moment in time. At this point, he noted that the fund may have gone over 100% funded around 1991 and that he was not concerned with the funding ratio at this time.

Surplus Earnings and the SDCERS Funded Ratio

During his service on the SDCERS Board, Mr. Woolever was not concerned with the funding ratio. Ms. Miller asked him at what point he would begin to worry about the funding level. He stated that the current level around 66% is a problem, but 85% would be an adequate "floor" for a municipality. Ms. Miller asked if this was his view during his service or was later acquired, and he replied that he was not sure. He did recall Board discussions about having a floor and a ceiling to make sure the fund was "there for the members."

Ms. Miller asked Mr. Woolever to explain his understanding of surplus earnings. Mr. Woolever defined surplus earnings as earnings beyond the 8% assumption. He recalled the Board receiving presentations on this topic, but could not recall how surplus earnings were calculated. Mr. Woolever recalled "walking through the Municipal Code" to determine the distribution of funds, and questioning this process during Board meetings. Ms. Miller asked if there were Board discussions about reinvesting surplus earnings into the fund. He did not recall discussions concerning the reinvestment of surplus earnings, but stated that he would not have thought this was necessary with 97% funding. He noted that the 97% funding ratio told him that the fund was collecting contributions from participants and the City that were too high. When asked whether surplus earnings should be used to smooth investment returns, Mr. Woolever stated that the employee and sponsor ideally should contribute a level amount every year and that surplus earnings are not to be reinvested after a good year. He noted that the market went up and down and that the City took their portion of the surplus and credited their contributions, and the employees received their portion of the surplus through the 13th check. Ms. Miller then asked if he felt that, as a Board member, he could force the City to make a certain contribution. He replied that the SDCERS Board could control City contributions by changing interest rate assumptions, but was not concerned during his SDCERS service that the City would be unable to meet its obligations to the system. At the time, the City had a good population and tax base, though Mr. Woolever believed this condition no longer exists. Mr. Turner asked if there were severe budgetary problems in the 1990's and Mr. Woolever responded that the City has always spent more than it could afford, but he was not concerned at the time about the City's pension contributions. Ms. Miller asked him how he reconciled his knowledge of the City's budget problems with his confidence in the City's ability to pay its pension contributions. Mr. Woolever admitted this may have been naïve, but he believed the City would not default on their legal obligation to fund the pension system.

Ms. Miller asked Mr. Woolever how the SDCERS Board was kept informed about the funding ratio. He responded that it was kept informed about the funding ratio by Mr. Roeder on an annual basis. Mr. Woolever did not recall if the Board was informed of the UAAL (Unfunded Actuarial Accrued Liability) from any additional sources, but felt that the amortization calculations were more the concern of the City Manager in connection with the budget process. Ms. Miller then asked for his understanding of post-retirement health care benefits. He responded that these benefits were not handled by SDCERS until the end of Mr.

Woolever's term. Prior to this time, Mr. Woolever believed that post-retirement health care was a City obligation, though the City may have "tapped surplus earnings" to pay the premiums.

Other Pension Issues

Mr. Woolever was shown a series of emails between himself and Cathy Lexin (Human Relations Director) on July 3, 2002, regarding pension calculations (Exhibit 4). Ms. Miller then asked if he recalled sending these emails. He did not recall sending these emails, but did recall hoping the 2.5% benefit at age 55 was approved. Regarding his comment in this email concerning certain Board members recusing themselves, Mr. Woolever noted that the same people that were negotiating the benefits with the City Manager were serving on the SDCERS Board. While this was also true during his service, he did not think about it at that time.

Mr. Woolever did not recall whether he served on the SDCERS Board for the Meet & Confer process leading up to MP1. He does not have files concerning this process and did not have a recollection about the financial status of the fund at that time, despite a sense that the funding ratio had decreased. He stated that "these kinds of issues were always bouncing around." Ms. Miller asked if he thought the decisions made by the SDCERS Board in 1995 led to the underfunding situation today. Mr. Woolever replied that it was possible, but the problem really began when the Board "waived the floor." Had they "held the line on the corridor floor," things may have turned out differently. Mr. Turner asked Mr. Woolever what he thought was the reason for the current underfunding situation. Mr. Woolever believed this was due to the fact that contributions could not match benefit levels as well as the fund's underperformance in the stock market. Mr. Woolever believed that if the pension fund is well-managed, it should outperform the market.

Regarding the PSC program, Ms. Miller asked if he was aware of any discussions regarding the pricing of these credits. Mr. Woolever stated that these credits were supposed to be priced at cost, and was surprised to read in the paper that they were being sold at a discount. He noted that he purchased credits himself, and felt that this was a good decision. On the whole, Mr. Woolever believed that "enlightened management provides employees with retirement" and that "4% is on the extreme low end." He expressed a concern that many employees are leaving to find better compensation in other jurisdictions, and noted that his (former) boss had recently left his job at the City and received greater salary and pension in a different municipality.

Ms. Miller then asked his opinion on the use of pension obligation bonds, and he stated that he supports Mayor Sanders' plan to sell pension obligation bonds because the current pension benefits remain a legal obligation of the City until a court declares otherwise. He noted that many jurisdictions have refinanced their pension obligations and this refinancing would get the SDCERS funded ratio near 85%.

Remediation

Ms. Miller asked Mr. Woolever what suggestions for remediation he would include if he were writing the Audit Committee's report. He stated that the changes in the composition of the Retirement Board have been beneficial, as they have included people with greater expertise in this area. Bankers or investment professionals bring more expertise to the Board, though they may have an agenda that is not always in the interest of the members. Mr.

Woolever then noted that it was the City which had negotiated a retirement increase in lieu of salary and did not disclose the unfunded liability in its bond offerings. Mr. Woolever opined that this disclosure was the City's responsibility and the focus on SDCERS Board members regarding this issue is misplaced.

Mr. Turner stated that the current composition of the Board includes seven appointed members and six from the labor side. Mr. Woolever expressed concern regarding this composition because he believed the employees should have a larger say since it is their money; political appointees look at system funds as taxpayer money, which is wrong. Mr. Turner said that the City needs to take its responsibility to the pension system seriously and requires a steady stream of cash to make their required contributions, but the City always seems to have a budget shortfall. He asked Mr. Woolever if the budget shortfall meant that taxes would need to be raised or programs cut from the budget. Mr. Woolever thought that there was another option since revenues can grow without tax increases. Since the City of San Diego is growing, so are revenues, and the Mayor has been able to make required contributions and also increase reserves. When Mr. Turner suggested that this approach may work only until the next economic downturn, Mr. Woolever admitted that it would require "discipline," but remained confident that the system will outpace market returns going forward. Mr. Woolever noted at this point that other employees left the City, but he remained a City employee in reliance on his pension.

Mr. Turner asked whether the City did monthly match-ups to the budget. Mr. Woolever stated that the City used Current Year Monitoring (CYM) on a period (quarterly) basis to match-up to budget. If a department was projected to go over budget during the year, mitigation measures would have been identified, and superiors would need to determine whether to reallocate resources. If all departments were over their budgets, there might be a hiring freeze or other cost-saving actions. There are also "fourth quarter adjustments" which are immitigable excess expenses that the Financial Management Department brought before the Council as part of year-end actions.

Ms. Miller then asked Mr. Woolever if he had any additional information he would like to add to his statements. He offered that the pension system is not the problem; the problem is the funding. Ms. Wilkinson, Mr. Torres, and Ms. Vattimo were all just trying to do what they thought were their jobs, but the Board is being scapegoated. He stated that they all got legal advice from Robert Blum (SDCERS Outside Counsel) and the City Attorney's Office, and that advice may not have always been the best. Mr. Turner asked if the Board should bring in separate counsel and an independent actuary for proposals like MP1 and MP2, and Mr. Woolever thought that would be a good idea.

Mr. Turner asked what would have helped Mr. Woolever in his role as SDCERS Board member, and he stated that there should be better training for Board members due to the complex nature of their task. He felt that orientation programs on Board members' fiduciary duties would be helpful, and noted that the City developed more of this kind of training under Mayor Murphy.

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